Internal Revenue Service

memorandum

CC:TL-N-1783-88
JCAlbro

date: JAN 22 1988

to: [redacted]

from: Acting Director, Tax Litigation Division CC:TL

subject: [redacted]

This is in response to the request of [redacted] dated December 7, 1987, for technical advice on several issues in the above-mentioned case. The issues involving pre-1971 regrouping of assets have been referred to the Interpretative Division; a copy of that request is attached. We are, therefore, presently responding to only the inside wiring issues.

ISSUES

1. What is the proper tax treatment of initial installation costs of inside wiring and will treatment change when a telephone company no longer owns the inside wiring? RIRA Nos. 0263.03-02; 0263.13-00; 0263.14-00.

2. Are reconnection and reinstallation costs (customer movement costs) intangible costs subject to amortization or are they currently deductible business expenses? RIRA Nos. 0263.03-02; 0263.13-00; 0263.4-00.

3. Does the 1981 FCC order requiring the expensing of all inside wiring costs obviate a company from filing a change in accounting method application in order to expense for tax purposes costs previously capitalized? RIRA No. 0446.04-05.

4. When a company no longer owns inside wiring and may expense rather than capitalize initial installation costs for tax purposes, is this a change in underlying facts such that a change in accounting method application is not required? RIRA No. 0446.04-05.

CONCLUSIONS

1. The initial installation costs of inside wiring should continue to be capitalized pursuant to Rev. Rul. 84-24, 1984-1 C.B. 89 until the ownership of the wiring is

transferred (either through state property law or regulatory action) from the company to the customer. When the company no longer owns the wiring, initial installation costs should be currently deducted.

2. Reconnection and reinstallation costs are currently deductible business expenses rather than intangible costs subject to amortization.

3. A taxpayer must file a change in accounting method application in order to expense reinstallation and reconnection costs, which were previously capitalized.

4. When a company no longer has title to inside wiring and expenses rather than capitalizes initial installation costs, such change in treatment results from a change in underlying facts and is not a change in method of accounting.

FACTS

Subscribers are connected to the telephone network by three different wiring segments:

1. The outside plant wire consists of the cable or wire which runs from the central office to the telephone pole or other terminal connections to the subscriber;

2. Drop and block is the wire running from the telephone pole or other terminal connections to the protector block or its equivalent at the subscriber's premise; and

3. Inside wire is the wiring inside the customer's premises from the protector block or equivalent to each station or jack.

Drop and block and inside wire are collectively referred to as station connections. Under the Uniform System of Accounts prescribed by the Federal Communications Commission (FCC), the costs of station connections, principally labor and wiring materials, were capitalized in Account 232. Inside wiring station connections can be divided into three categories: new installations, reconnections and reinstallations. The installation of inside wire at premises which did not previously have service is a new installation. The restoration of service to premises which previously had service but where the telephone equipment had not been removed is a reconnection. If equipment had been removed, the restoration of service is a reinstallation.

Beginning in [redacted] treated all costs relating to inside wire, whether a new installation, reinstallation or reconnection as capital expenditures for tax purposes and claimed accelerated depreciation and investment tax credit.

On March 31, 1981, the FCC issued its First Report and Order, 85 FCC 2d 818 (1981), in which it authorized the expensing of inside wiring costs incurred after October 1, 1981. The FCC concluded that the costs in Account 232 allocable to drop and block wiring should continue to be capitalized. In permitting the expensing of inside wiring costs, the FCC found that much of the activity in Account 232 and much of the companies' investment in recent years consisted of costs incurred by customer movement rather than by installations of new inside wiring. Approximately 85% of the telephones installed by companies in the five years preceding the order represented resumption of previously disconnected service rather than new installations. The FCC held that it would be in the public interest to have the customer who created the inside wiring expense, whether an initial installation or reconnection bear the cost. Capitalization and charges which did not fully recover cost would require that all customers share that burden. Therefore, the FCC ruled that if authorized by the state regulatory commission, a telephone company could charge the current customer full freight for installing or reconnecting an inside wiring station and expense the related costs in the same year.

On [redacted] filed a Form 3115 on behalf of [redacted] seeking permission to deduct inside wiring costs in the year incurred in a manner conforming to the FCC prescribed treatment. In apparent anticipation of a denial of the application, it was withdrawn.

[redacted] applied to the Public Utility Commission (PUC) for permission to increase charges and expense all inside wiring station connection costs, and the order approving the change was made [redacted]. The charges approved for deductible expense treatment were an access line connection charge, a time and materials charge, a jack charge (materials) and other jack and complex business premises wiring charges. Upon authorizing the expensing of these charges, the PUC adjusted [redacted] s intrastate rate base, revenues, and rate of return to reflect the loss of future rate base and revenue.

In Further Notice of Inquiry, 86 FCC 2d 885(1981) the FCC proposed to allow companies to offer inside wiring installation services on a nonregulated basis. In 1984, the FCC adopted a program under which certain business and residential inside wiring could be provided and directly connected to the telephone network by entities other than the telephone company. First Report and Order 97 FCC 2d 527 (1984). In Further Notice of Proposed Rulemaking, 50 F.R. 13991 (April 9, 1985) the FCC proposed to detariff the installation of inside wiring and its maintenance. It also proposed that companies relinquish all claims to ownership of the inside wiring when such costs have been fully amortized and companies have a zero net investment in inside wiring. The FCC also stated that detariffing of inside wiring would enable electricians, contractors and home builders to provide installation of wiring on a competitive basis with telephone companies.

The FCC recently ordered, see Second Report and Order in CC Docket No. 79-105, that installation and maintenance of inside wiring shall not be offered pursuant to tariff after December 31, 1986 and that state public utility commissions may not impose tariff regulation on installation or maintenance. It also ordered that telephone companies shall relinquish the ownership of inside wiring previously expensed no later than January 1, 1987 and that for inside wiring still recorded in Account 232, relinquishment of ownership will be effective on the date such investment has been fully amortized.

The adjustments at issue in this case disallow expensing of any inside wiring costs. In addition, station reconnection and reinstallation costs are treated as intangible costs subject to amortization and ineligible for accelerated depreciation and investment tax credit. The statutory notice takes the position that reconnection and reinstallation costs are separate and distinct capital assets generating future income as long as customers remain connected to the network. Accelerated depreciation is not available because the costs do not involve construction or reconstruction of tangible assets. Similarly, investment tax credit is not available because the costs do not relate to construction, reconstruction, erection or acquisition of physical assets and thus do not relate to tangible, depreciable assets.

DISCUSSION

Service Position on inside wiring is stated in Rev. Rul. 84-24, 1984-1 C.B. 89 and Rev. Rul. 86-118, 1986-2 C.B. 5. In addition, the Commissioner has issued two private letter rulings on the issue to [redacted] PLR 8451020, September 12, 1984 and PLR 8640013, June 30, 1986.

Rev. Rul. 84-24 concerns whether the costs of installing inside wiring should be currently expensed or capitalized. The revenue ruling relies on Rev. Rul. 82-12, 1982-1 C.B. 52 in which the costs of replacing overhead drop lines with buried cable were capital expenditures in the nature of a replacement or a permanent improvement. In Rev. Rul. 84-24, the taxpayer maintains and repairs the inside wiring and has title to it. The ruling concludes that the taxpayer has an identifiable asset used in its business with a useful life extending beyond one year. Accordingly, the installation of the inside wiring is in the nature of a permanent improvement. The fact that the FCC allows expensing of such costs does not negate its character as a capital expenditure for Federal income tax purposes. The ruling also provides that accelerated depreciation under section 168 is appropriate.

Rev. Rul. 86-118 is related to Rev. Rul. 84-24 and with the same factual situation concludes that a taxpayer does not violate the ratable flow through requirements of section 46(f)(2) when for regulatory purposes it expenses the cost of inside wiring and, in the year of the expense, reduces cost of service by the full amount of the investment tax credit allowable with respect to the inside wiring.

In the 1984 PLR taxpayer proposed to change its treatment of inside wiring costs to conform to the 1981 FCC order which allowed the expensing of inside wiring costs. Taxpayer asserted that Rev. Rul. 84-24 was distinguishable because unlike the ruling it did not retain basic ownership rights in the inside wiring. The ruling noted that whether taxpayer retained legal title to the inside wiring in the jurisdiction in which it does business is a question of fact. Due to lack of evidence offered by taxpayer on this issue, the Commissioner was not convinced that taxpayer had not retained legal title. Therefore, Rev. Rul. 84-24 was held to be controlling and requires the capitalization of initial installation of inside wiring.

The 1986 ruling is a reconsideration of the 1984 ruling. It concerns the tax treatment of the installation costs of inside wiring and refers to Rev. Rul. 84-24's holding that the installation of inside wiring must be capitalized. Taxpayer again asserted that unlike the Rev. Rul., it does not own the inside wiring post-1981 (the FCC order). The ruling again reasons that the taxpayer has not established that it does not own the wiring in the context of the regulatory changes through 1986. The ruling does agree, though, that if a utility does not own the inside wiring, the installation cost should not be capitalized.

I. Initial Installation of Inside Wiring

Rev. Rul. 84-24, 1984-1 C.B. 89 provides that the intial installation of inside wiring is a capitial expenditure when the utility maintains and repairs the wiring and has title to it. We believe that this is the proper tax treatment until the company no longer owns the wiring. When they no longer own the wiring, they cannot be required to capitalize such costs; rather, the costs will be currently deductible business expenses.

The point in time in which a company will no longer own the inside wiring is a question of fact which will vary from state to state. Telephone company practice concerning inside wiring installations are governed by tariffs filed with state public utility commissions. These tariffs not only set forth charges, classifications, regulations and practices but they define the contractual rights of the company and its customers. State tariffs will vary for some time regarding whether customers own the inside wiring. See Second Report and order in CC Docket No. 79-105: telephone companies shall relinquish ownership of inside wiring previously expensed to Account 605 no later than January 1, 1987 and for inside wiring recorded in Account 232, relinquishment of ownership shall be on the date such investment has been fully amortized.

In addition, it is obvious that once inside wiring may be installed by anyone and maintenance is no longer the sole responsibility of the telephone company, it is not appropriate to capitalize initial installation costs as relating to telephone company assets. Rev. Rul. 84-24 is no longer applicable when a company does not have title and is not responsible for maintenance and repair of wiring.

The taxable year in which [redacted] will no longer have title to inside wiring and thus no longer capitalize installation costs for federal tax purposes will be determined by the appropriate local regulatory authority.

II. Reconnection and Reinstallation Costs

Rev. Rul. 84-24 refers specifically to the "installation of inside wiring" with respect to its holding that such costs are in the nature of a permanent improvement and must be capitalized. It is our opinion that the Rev. Rul. does not preclude the expensing of reconnections and reinstallation costs. Discussions with Corporation Tax staff who worked on the revenue ruling confirm that Division's view that reconnection and reinstallation costs are deductible expenses pursuant to section 162.

Income is usually clearly reflected when ordinary and necessary business expenses are deducted in the taxable year paid or incurred and capital expenditures are deducted over the period benefitted. Treas. Reg. § 1.446-1(c).

A deduction may be taken for ordinary and necessary expenses in carrying on a trade or business, I.R.C. § 162(a), but not for any permanent improvements or betterments made to increase the value of any property. I.R.C. § 263(a)(1). Outlays for repairs may be either an expense deduction or a capital expenditure based upon the nature and extent of the repairs. The two applicable Treasury regulations provide:

> The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as an expense.... Repairs in the nature

> of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, shall either be capitalized and depreciated... or charged against the depreciation reserve if such an account is kept.

Treas. Reg. § 1.162-4

> In general, the amounts referred to in paragraph (a) of this section include amounts paid or incurred (1) to add to the value, or substantially prolong the useful life, of property owned by the taxpayer, such as plant or equipment, or (2) to adapt property to a new or different use. Amounts paid or incurred for incidental repairs and maintenance of property are not capital expenditures....

Treas. Reg. § 1.263(a)-1(b).

In determining the characterization of a particular item it is also necessary to ascertain the purpose for which the expenditure is made. If its purpose is merely to keep the property or a machine in efficient operating condition and is accordingly in the nature of a maintenance charge, it is deductible. 6 J. Mertens, Law of Federal Income Taxation, § 25.26, at 217 (Rev. 1985). The purpose of repairs is most often to continue proper operation for the duration of an asset's expected life or to maintain normal output and capacity.

It is our opinion that the costs of reconnection and reinstallations of inside wiring are analogous to deductible repair expenses and are neither use expanding nor life extending to make them capital expenditures. Such expenses are recurrent and are a function of customer life not the life of the asset (inside wiring). Such expenses do not add value to the asset but merely maintain the asset in operating condition. Unlike drop and block wiring which is unaffected by customer movement, inside wiring reconnections and reinstallations are recurrent costs dependent upon individual customers and are not in the nature of a capital investment in the existing inside wiring asset of the company.

We disagree with the position that these costs create an intangible asset. We do not believe that an intangible asset is created when a customer has telephone service restored at a location. The tangible wiring asset is being returned to service, but there is no intangible asset in the nature of a contract, patent, goodwill etc. See First Nat'l Bank of S.C. v. United States, 558 F.2d 721 (4th Cir. 1977) (no intangible asset; no creation of a property interest with intrinsic or salable value). In Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775 (2d Cir. 1973), the Second Circuit found no intangible capital asset where franchise contracts produced business benefits over future years. Although the Service does not agree with the Briarcliff decision, it demonstrates that a more nebulous assertion of an intangible asset would not likely be sustained in litigation. See also Connecticut Light & Power Co. v. United States, 299 F.2d 259 (Cl. Ct. 1962) (conversion costs of appliances which neither added to value nor prolonged life are deductible expenses not capital expenditures). In Iowa-Des Moines Nat'l Bk. v. Commissioner, 68 T.C. 872, 878-79 (1977) the Tax Court noted that expenditures to acquire assets or secure benefits which last beyond the taxable year must be capitalized. Nevertheless, the mere presence of some possible future benefits from an expenditure is not controlling where such payment was made to promote the taxpayer's existing business and does not create or enhance a separate and distinct asset or property interest.

The statutory notice position that reconnection and reinstallation costs must be capitalized or amortized because they provide future benefits does not comport with the fact that such costs result from the movement of customers from one location to another. Such costs are clearly recurrent costs, not capital investments.

We believe that in conformity with Commissioner v. Idaho Power Co., 418 U.S. 1 (1976) the proper tax treatment of the costs at issue is deductible expenses. The Court states, 418 U.S. at 15, that where a taxpayer's generally accepted method of accounting is made compulsory by the regulatory agency and that method clearly reflects income, it is almost presumptively controlling of federal income tax consequences. These costs, though previously in the rate base, as a result of the FCC order will now be charged to the customer directly. Current deduction of these expenses will thus match the expense with the related income obtained from customers.

III. Change in Accounting Issues

Treas. Reg. § 1.446-1(e)(2)(ii)(a) defines a change in method of accounting:

> A change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. Although a method of accounting may exist under this definition without the necessity of a pattern of consistent treatment of an item, in most instances a method of accounting is not established for an item without such consistent treatment. A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction.

Treas. Reg. § 1.446-1(e)(ii)(b) provides that adjustments which do not involve the proper time for inclusion of an item in income or taking of a deduction are not changes in accounting method. Specifically, this regulation provides as follows:

> A change in method of accounting does not include correction of mathematical or posting errors, or errors in the computation of tax liability (such as errors in computation of the foreign tax credit, net operating loss, percentage depletion or investment credit). Also, a change in method of accounting does not include adjustment of any item of income or deduction which does not involve the proper time for the inclusion of the item of income or the taking of a deduction. For example, corrections of items that are deducted as interest or salary, but which are in fact payments of dividends, and of items that are deducted as business expenses, but which are in fact personal expenses, are not changes in method of accounting. A change in the method of accounting also does not include a change in treatment resulting from a change in underlying facts. On the other hand, for example, a correction to require depreciation in lieu of a deduction for the cost of a class of depreciable assets which had been consistently treated as an expense in the year of purchase involves the question of the proper timing of an item, and is to be treated as a change in method of accounting.

It is our opinion that a proposed change from capitalizing to expensing reconnection and reinstallation costs requires a change in accounting method application. Nothwithstanding the FCC order, such a change is a change in the treatment of a material item involving the proper time for the taking of a deduction. Service position is that the existence of a timing question is the principal criterion in the definition of a change in method of accounting. As discussed, supra, we believe the proper tax treatment is the expensing of reconnection and reinstallation costs rather than the previous treatment as capital expenditures. The regulation quoted supra discusses the example of a correction to require depreciation in lieu of a deduction for the cost of depreciable assets which had been consistently treated as an expense in the year of purchase and states the change involves the question of the proper timing of an item, and is to be treated as a change in method of accounting. All accounting practices which relate to the time when an item should be taken into account are considered accounting methods. See 1970-2 C.B. 98.

The regulation, though, provides an exception for a change in treatment resulting from a change in underlying facts. As discussed, supra, PLR 8640013, June 30, 1986 notes that if telephone companies do not own the inside wiring, they cannot be required to capitalize such costs. Furthermore, whether a company has title to inside wiring in the jurisdictions in which business is conducted is a question of fact, the answer to which will depend on local property law and/or applicable regulatory law. The FCC has ordered that telephone companies shall relinquish ownership of inside wiring no later than January 1, 1987. With respect to inside wiring previously capitalized and amortized for regulatory purposes, relinquishment of ownership will be effective on the date such investment has been fully amortized. Second Report and Order in CC Docket No. 79-105. The exact date that companies will no longer own inside wiring will vary. It is our opinion that the change in treatment to expensing initial installation costs will result from a change in the underlying fact of ownership pursuant to FCC order. A similar conclusion is reached in PLR 8746076, August 20, 1987 where taxpayer's change in the manner in which incremental fuel costs are recovered from customers, pursuant to a change in state law, is held to be a change in treatment resulting from a change in underlying facts and not a change in method of accounting. Although timing of income and deduction issues were involved, the state law created a change in underlying facts, and therefore a change in accounting method application was not necessary.

If you have any further questions, please contact Joyce C. Albro at 566-3521.

PATRICK J. DOWLING
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Attachment:
Memo to Interpretative Division